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BEFORE THE ARIZONA CORPORATION COMMISSION  
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Arizona Corporation Commission  
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**COMMISSIONERS**

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2011 DEC -2 P 4:10

DEC 8 2011

AZ CORP COMMISSION  
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IN THE MATTER OF THE APPLICATION OF  
GOODMAN WATER COMPANY, AN ARIZONA  
CORPORATION, FOR (i) A DETERMINATION  
OF THE FAIR VALUE OF ITS UTILITY PLANT  
AND PROPERTY AND (ii) AN INCREASE IN  
ITS WATER RATES AND CHARGES FOR  
UTILITY SERVICE BASED THEREON.

DOCKET NO. W-02500A-10-0382

**STAFF'S OPENING BRIEF**

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") hereby files its closing brief in the above captioned matter. The brief addresses the disputed issues regarding the Proposed Settlement Agreement dated September 15, 2011, between Goodman Water Company ("Goodman" or "Company"), and Intervenors James Schoemperlen, Lawrence Wawrzyniak, and the Residential Utility Consumer Office ("RUCO"). On any issue not specifically addressed in this brief, Staff maintains its position as presented in its testimony.

**I. INTRODUCTION.**

Goodman Water Company is an Arizona for-profit, Class C public service corporation providing water service to approximately 600 customers in the vicinity of Oracle in Pinal County, Arizona. On September 17, 2010, Goodman filed an application for a permanent rate increase, requesting a return on a \$2,402,222 fair value rate base ("FVRB"). Goodman's Rebuttal testimony requests a \$262,717 (44.19 percent) revenue increase to provide a \$227,309 operating income for a 9.89 percent rate of return on a \$2,298,376 FVRB.

A hearing in this matter commenced on July 26, 2011, continued through July 28, 2011, and was scheduled to reconvene on September 12 and 13, 2011, until vacated to accommodate preparation of a settlement agreement and supporting testimony by some of the parties (Goodman and Intervenors RUCO, Lawrence Wawryzniak and James Schoemperlen) that had come to terms regarding significant disputed issues. Staff was not invited to participate in the settlement discussions and was unaware that the discussions were taking place until an agreement in principle had been

1 reached regarding the rate application.

2 The Proposed Settlement Agreement was filed on September 15, 2011. Pursuant to a  
3 September 15, 2011, Procedural Order, the parties to the Proposed Settlement Agreement submitted  
4 testimony in support of the agreement. Thereafter, Staff submitted its Supplemental Staff Report,  
5 which addressed the Proposed Settlement Agreement and the settling parties' supporting testimony.  
6 The Staff Report identifies reasons the Proposed Settlement Agreement as filed should not be  
7 adopted and identifies an alternative that preserves most of the Proposed Settlement Agreement's  
8 claimed benefits while avoiding certain problems that the agreement presents.

9 Staff's Supplemental Staff Report also updates its previously filed schedules and proposes a  
10 revenue requirement of \$797,063. This represents an increase of \$202,604, or 34.08 percent, over test  
11 year revenue of \$594,459 for a 9.2 percent rate of return on a Staff-adjusted FVRB of \$2,077,253.  
12 Staff's updated revenue requirement represents a \$21,780 increase from its initial Surrebuttal  
13 testimony. Staff's updated revenue requirement reflects a correction to remove Advances in Aid of  
14 Construction related to mains that were double counted in the calculation of accumulated deferred  
15 income taxes; adjustments to Land and Structures and Improvements to recognize the fully-allocated  
16 cost of purchases from an affiliate; and the consequential effects on depreciation expense,  
17 accumulated depreciation, property and income taxes and rate design.

18 Staff recognizes the efforts and cooperation of the parties to the Proposed Settlement  
19 Agreement in attempting to resolve the issues in this case. However, there are elements of that  
20 agreement with which Staff cannot agree. These include the 'black box' nature of the settlement  
21 terms, which leaves undecided those issues which must be resolved in order to serve as a basis for  
22 any future rate application that may be filed, and the deferral of both accumulated depreciation and  
23 annual depreciation expense.

24 **II. A BLACK BOX FORMAT FAILS TO ESTABLISH THE ELEMENTS REQUIRED**  
25 **FOR A FUTURE RATE CASE.**

26 The Proposed Settlement Agreement states: "The parties present agreed that the settlement  
27 would take the form of a "black box" format in which only the specific issues identified herein would  
28 be agreed to but that no specific revenue/expense, or rate base adjustments would be specifically

1 delineated.”<sup>1</sup> A determination on the issue of excess capacity was expressly postponed to the next  
2 rate case, and without that determination, there can be no determination of plant excluded or  
3 accumulated depreciation balances.

4 Although this language in the Proposed Settlement Agreement would suggest that none of the  
5 underlying elements, those which would be necessary for determining the revenue requirement in a  
6 future rate case has been agreed upon, at hearing, both RUCO<sup>2</sup> and the Company<sup>3</sup> presented  
7 testimony to the effect that the specific terms proposed by RUCO in the Surrebuttal testimony of  
8 Timothy J Coley and William A. Rigsby constituted the various elements upon which the revenue  
9 requirement and rates could be based, and that the Recommended Opinion & Order could so indicate  
10 without violating the terms of the Proposed Settlement Agreement.

11 Adoption of the of RUCO’s position as set forth in its Surrebuttal testimony would resolve  
12 most of the problems created by a ‘black box’ agreement and would provide sufficient information on  
13 which to base a future rate case. One exception is the determination of the value of the land, together  
14 with structures and improvements thereon which were transferred to the Company by an affiliate.  
15 NARUC Guidelines for Cost Allocations and Affiliate Transactions provide that the transfer of assets  
16 from an affiliate should be at the lower of market price or net book value and that an appraisal should  
17 be conducted to determine market price.<sup>4</sup> The Company proposed recording the value of the land and  
18 improvements based on an appraisal conducted by John Ferenchak, III,<sup>5</sup> (the “Appraisal”) but  
19 declined to provide the book value of the land, structures and improvements.<sup>6</sup> Staff’s pre-settlement  
20 position was that the parcels should be excluded from rate base until the Company provided the  
21 requested information and that, in the meantime, the 2009 Pinal County Assessor’s Full Cash Value  
22 should be used as a place holder.<sup>7</sup>

23 In arriving at its FVRB of \$1,755,118, RUCO assigns the land, structures and improvements a  
24 lower value than that contained in the Appraisal, but utilizes a theory which might suggest that it also

25 \_\_\_\_\_  
<sup>1</sup> Proposed Settlement Agreement, at paragraph 1.15.

26 <sup>2</sup> Tr. Vol. V at 871:24-872:16.

27 <sup>3</sup> Tr. Vol. IV at 755:15-756:6.

28 <sup>4</sup> Ex. S-19 at 11 (Surrebuttal Test. of Gordon L. Fox).

<sup>5</sup> Tr. Vol. II 236:9-17; Ex. S-19 at 11-15 (Surrebuttal Test. of Gordon L. Fox).

<sup>6</sup> Ex. S-19 at 12 (Surrebuttal Test. of Gordon L. Fox).

<sup>7</sup> Ex. S-19 at 17 (Surrebuttal Test. of Gordon L. Fox).

1 adopts the appraisal value urged by the Company. RUCO's Surrebuttal Testimony states the  
2 Appraisal's value of the land but discounts it by a standardized percentage to reflect the portion that it  
3 deems to be used and useful.<sup>8</sup> Arguably, this could be interpreted as adopting the Company's  
4 valuation. For this reason, Staff continues to assert that the Proposed Settlement Agreement not be  
5 adopted. However, in the event that it is adopted, any order should clarify that the land valuation on  
6 which the Proposed Settlement Agreement is based is not adopted and shall be determined in a future  
7 rate case.

8 **III. DEFERRAL OF DEPRECIATION AS PROPOSED IS CONTRARY TO**  
9 **ACCOUNTING AND RATEMAKING PRINCIPLES ADOPTED BY THIS**  
10 **COMMISSION.**

11 **A. No Accounting Methodology Exists to Defer Accumulated Depreciation.**

12 The Proposed Settlement Agreement includes a provision that Goodman is authorized, for  
13 rate-making purposes, to "defer \$269,307 of accumulated depreciation through the end of the test  
14 year."<sup>9</sup> The very concept is self-contradictory: accumulated depreciation is that which has been  
15 accumulated and recorded or 'taken' while depreciation that is deferred has not been 'taken' or  
16 recorded. Given that the same depreciation cannot be both recognized as an expense in or before the  
17 test year and deferred to a future date, it appears that, in effect, the Proposed Settlement Agreement  
18 attempts to undo or void the recording of accumulated depreciation that existed at the end of the test  
19 year.

20 However, no accepted methodology for either voiding or deferring depreciation which has  
21 already been accrued exists. The Commission has adopted NARUC's Uniform System of Accounts  
22 (USOA); neither the USOA nor Generally Accepted Accounting Principles (GAAP) provides for  
23 such a deferral or reversal of recorded accumulated depreciation.<sup>10</sup> In fact, certain provisions of  
24 USOA and GAAP indicate that such a reversal is improper. The USOA states:

25 All prior period adjustments to retained earnings shall be approved by the  
26 Commission....Generally the **only** type of transactions which will be considered as a  
27 prior period adjustment are correction of an error in the financial statements of a prior  
28 period, or adjustments that result from realization of income tax benefits of pre-  
acquisition loss carry-forwards of purchased subsidiaries.

<sup>8</sup> Ex. RUCO-8 at Surrebuttal Schedule TJC-6 (Surrebuttal Test. of Timothy J. Coley).

<sup>9</sup> Proposed Settlement Agreement, at Paragraph 2.3.

<sup>10</sup> Tr.955:23-956:15.

1 In the present case, the accumulation of depreciation could not be considered an error, nor is it  
2 among the types of transaction which can be changed. Thus any changes in depreciation or  
3 amortization amounts would not be considered an error and would not be allowed as an adjustment to  
4 retained earnings.<sup>11</sup>

5 Other authorities support Staff's position in this regard. *The Regulation of Public Utilities*  
6 *Theory and Practice*, by Charles F. Phillips, Jr, states: "If therefore, public utilities fail to make  
7 adequate charges to cover depreciation costs and do not accumulate the necessary depreciation  
8 reserves, they cannot increase their charges at a later time in order to recover deficiencies from  
9 customers."<sup>12</sup> While not directly addressing the issue in this case, Mr. Phillips' statement is another  
10 indication that depreciation and accumulated depreciation amounts should be recorded properly and  
11 not manipulated.<sup>13</sup>

12 **B. Deferral Of Either Accumulated Depreciation Or Annual Depreciation Expense**  
13 **Results In Rates That Are Neither Fair Nor Reasonable.**

14 **1. Intergenerational Transfer Of Costs.**

15 Among the most basic precepts of cost-of-service ratemaking is that rates should be based on  
16 the cost of service to the customers who create those costs.<sup>14</sup> The deferral of depreciation in this case  
17 will almost certainly result in an intergenerational transfer of those costs to future ratepayers. At issue  
18 in this case, and unresolved by the Proposed Settlement Agreement, is the issue of whether there is  
19 excess capacity in the system. Both Goodman and Staff have presented extensive evidence that there  
20 is no excess capacity at this time. Only the Interveners dispute this.

21 The plant in controversy includes a storage tank and mains. Without a determination or even a  
22 consensus that this plant is not used and useful, it is highly likely that, when the issue of excess  
23 capacity resurfaces in the next rate case, at least a portion of the excluded plant will be deemed to  
24 have been used and useful. In this case, Goodman has agreed to a stay-out period of more than three  
25 years, with the earliest test year occurring in 2014. This plant was placed in service in 2008. By the  
26

27 <sup>11</sup> Tr.958:6-12.

28 <sup>12</sup> Charles F. Phillips, Jr., *The Regulation of Public Utilities Theory and Practice*, p.247.

<sup>13</sup> Tr.961:8-10.

<sup>14</sup> *Regulated Utilities Manual*, Deloitte, p. 6; Fox Transcript p. 964, 1.0-17.



1 time this plant is included in rates, no earlier than early 2016, it is anticipated that growth will have  
2 occurred and that the new ratepayers can help in paying for the plant in question. However, by that  
3 time, the current residents will have had approximately eight years of use of the plant but the cost  
4 thereof will be shifted to new home owners.

5 This also raises the specter of retroactive ratemaking. Retroactive ratemaking occurs when  
6 future rates permit a utility to recoup past losses or refund excessive past income. This can include  
7 changes in accounting methodology which impact past losses or gains.<sup>15</sup> For instance, the Court in  
8 *Montana-Dakota Utility Company vs. Public Service Commission*<sup>16</sup> found that retroactive ratemaking  
9 had occurred when the public service commission required a utility to re-compute its unamortized  
10 investment tax credit balance to reflect a 26 year period rather than the 20 year period the utility had  
11 computed.

12 The District of Columbia Circuit of the United States Court of Appeals has also  
13 acknowledged that changing accounting methodology can result in retroactive ratemaking in *Town Of*  
14 *Norwood, Massachusetts v. Federal Energy Regulatory Commission*.<sup>17</sup> That case involved a change  
15 from cash basis to an accrual accounting method for treatment of post-retirement benefits other than  
16 pensions, primarily retiree medical benefits. Switching from pay-as-you-go to accrual accounting  
17 results in a large liability – the transition obligation. That liability may be amortized over 20 years.  
18 The Court ruled that, because the company was not shifting any costs that it should have collected in  
19 the past, it was not retroactive ratemaking. (Both methods were a means of having present employees  
20 bear the cost of their own retirement benefits in the future and the cost being recovered would always  
21 have been collected in the future.)

22 This might suggest that the deferral of depreciation here is retroactive ratemaking. However,  
23 Arizona has not so ruled, and there exists little case law in this area to provide guidance. Arizona  
24 recognizes the rule against retroactive ratemaking, but, to date, has not addressed any circumstances  
25 other than those wherein rates were adjusted as either too high or too low and the difference was to be

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26 <sup>15</sup> Krieger, Stephan H., *The Ghost Of Regulation Past: Current Applications Of The Rule Against Retroactive Ratemaking*  
27 *In Public Utility Proceedings*, University of Illinois Law Review, 1991, at p. 998.

28 <sup>16</sup> *Montana-Dakota Utility Company vs. Public Service Commission*, 431 N.W.2D 276 (N.D.1988).

<sup>17</sup> *Town Of Norwood, Massachusetts v. Federal Energy Regulatory Commission*, 162 P.U.R.4th 214, 53 F.3d 377, 311  
U.S.App.D.C. 306 (1995).

1 recouped or refunded in new rates.<sup>18</sup> Nor did the Courts of Appeals find that retroactive ratemaking  
2 had occurred. Both involved cases wherein the Commission had approved rates only to later order  
3 that amounts it determined to have been excessive must be refunded. In *Pueblo Del Sol*, the rates in  
4 question were interim rates, not final rates, so the rule did not apply. In *Mountain States*, the  
5 Commission had not set aside its own rate order. That order was mandated to be set aside by the  
6 Arizona Court of Appeals, so the rule was inapplicable.

7 **2. Goodman Will Receive The Benefit Of Accumulated Depreciation Twice.**

8 Perhaps more concerning than the issue of retroactive ratemaking, is the impact that the terms  
9 of the agreement will have on current ratepayers and future ratepayers who have neither created the  
10 cost nor agreed to its deferral. As noted, Goodman has already recorded its accumulated depreciation  
11 balance at the end of the 2010 test year. The books have been closed on that year and previous years  
12 and cannot now be re-opened and amended. The ratepayers who paid rates in 2010 and before bore  
13 the costs of the excluded tank in the rates they paid. This cannot be undone. Therefore, if the  
14 Company is permitted to defer that accumulated depreciation until the next rate case sometime after  
15 January 1, 2015, the accumulated depreciation will be included in rates again and the customers will  
16 pay for that a second time.

17 **3. Ratepayers Will Overpay Annual Depreciation Expense.**

18 The Proposed Settlement Agreement does not specify how the deferred depreciation will be  
19 treated, only that it will be deferred. Company witness Thomas J. Bourassa testified that it was his  
20 understanding that the deferred depreciation, both the accumulated depreciation of \$269,307 and the  
21 annual depreciation expenses of \$44,136, would be addressed at the next rate hearing and that, in the  
22 interim, that depreciation would be accumulated.<sup>19</sup> Mr. Rigsby concurred with this position<sup>20</sup>. By the  
23  
24

25 <sup>18</sup> Arizona case law provides little guidance in the present circumstance. In *Pueblo Del Sol Water Co. v. Arizona Corp.*  
26 *Commission*, 160 Ariz. 285, 287, 772 P.2d 1138, 1140 (App. 1988). The Arizona Court of Appeals stated, "Retroactive  
27 rate making occurs when the Commission requires refunds of charges fixed by a formal finding which has become  
28 final." <sup>18</sup> In *Mountain States Tel. & Tel. Co. v. Arizona Corp. Commission*, 124 Ariz. 433, 436, 604 P.2d 1144, 1147  
(App. 1979), the court stated: "When an agency approves a rate, and the rate becomes final, the agency may not later on  
its own initiative or as the result of collateral attack make a retroactive determination of a different rate and require  
reparations."

<sup>19</sup> Tr. 768:7-769:18.

<sup>20</sup> Tr. 873:9-874:16.

1 end of the 2014 test year, the amount accumulated would be \$489,987. This amount would then be  
2 amortized and included in rates as an operating expense.

3 This gives rise to multiple concerns. First is the extent to which the Commission in a future  
4 rate case would allow the depreciation to be recovered. The USOA provides that such a regulatory  
5 asset be maintained in a separate account, but also states that "If rate recovery of all or part of an  
6 amount included in this account is disallowed, the disallowed amount shall be charged to Account  
7 426 – Miscellaneous Nonutility Expenses, or Account 434 – Extraordinary Deductions, in the year of  
8 the disallowance."<sup>21</sup> Given the significant impact of a disallowance, it is unlikely that the  
9 Commission will not, in the future, disallow it.

10 Second is the financial impact this will have on ratepayers. If there is no deferral and the  
11 accumulated and annual depreciation are considered in this rate case, then there will be the \$269,307  
12 accumulated depreciation which is a reduction in rate base, and one year of annual depreciation  
13 expense of \$44,136. In contrast, if the deferral is authorized, the next rate case will include recovery  
14 of the accumulated depreciation balance and four years of annual depreciation deferred in addition to  
15 the on-going depreciation expense of the test year. Thus future ratepayers will be paying not only  
16 their own on-going annual depreciation, but also the amortized annual and accumulated depreciation  
17 deferrals. The Proposed Settlement Agreement's omission of the specified treatment exposes future  
18 ratepayers not only to the amortization expense but also to the potential that the deferred amount  
19 could be included in rate base, which, as previously noted, would be the likely outcome. Under that  
20 assumption, Staff's alternative is really more appealing for the ratepayer in the long term because,  
21 even though he must pay a little more up front, he does not pay as much in the long run.

22 C. **Staff's Alternative Achieves the Same Rates Without Relying on Questionable**  
23 **Accounting Practices.**

24 It is a long-recognized legal maxim that hard cases make bad law. In this case, the parties to  
25 the Proposed Settlement Agreement have agreed to rates which are acceptable to all parties, but base  
26 those rates on methods inconsistent with those adopted by the Commission. This creates the risk that  
27 other utilities will rely on this methodology in future cases. Although the Proposed Settlement  
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<sup>21</sup> USOA 186.3(D).



1 Agreement specifies that it relies on a black-box method and that no specific terms have been agreed  
2 to, all parties thereto have now agreed that the specifics posed by RUCO in its Surrebuttal testimony  
3 may be adopted to support the rates of the Proposed Settlement Agreement.<sup>22</sup>

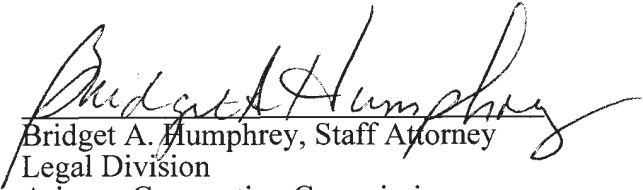
4 Yet the concept of deferral of depreciation remains. As noted, it is not accepted by either the  
5 USOA or GAAP and it results in rates that are not fair and reasonable and that require future  
6 generations of ratepayers to bear the cost of plant used by current ratepayers. It is more than a timing  
7 issue, despite the implications to the contrary. It results in the ratepayers paying twice for deferred  
8 accumulated depreciation and four times for the annual depreciation expense. Nor is it clear that the  
9 ratepayers who agreed to these terms understand their implications as to future rates.

10 For these reasons, Staff has proposed an alternative that allows the Commission to achieve the  
11 rate results without creating a precedent for accounting practices with apparently unintended  
12 consequences. To accomplish this, Staff proposes adopting its recommendations regarding rate base,  
13 operating expenses and depreciation rates and retaining the revenue requirement and revenue increase  
14 (with the three-year phase-in), the rate design and the Stay-Out provisions.

15 **IV. CONCLUSION.**

16 Staff respectfully requests that the Commission adopt its recommendations on the disputed  
17 issues for the reasons stated above and the testimony provided.

18 RESPECTFULLY SUBMITTED this 2<sup>nd</sup> day of December, 2011.

19  
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21   
22 Bridget A. Humphrey, Staff Attorney  
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24 Arizona Corporation Commission  
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28 <sup>22</sup> It should be noted that only Bourassa and Rigsby so testified, but the remaining intervenors did not dispute their position.

1 Original and thirteen (13) copies  
2 of the foregoing were filed this  
2<sup>nd</sup> day of December, 2011 with:

3 Docket Control  
4 Arizona Corporation Commission  
1200 West Washington Street  
5 Phoenix, Arizona 85007

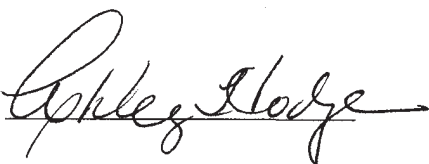
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